Europe's policies aimed at phasing out long-term gas supply contracts expose mid-stream suppliers to global price volatility

European Commission's latest market rules call for non-extension of long-term gas supply contracts beyond 2049 as part of the EU's gas sector decarbonisation and energy transition goals.

Negotiations between sellers and buyers around long-term supply deals - their structure, price formation and duration - has been going on for years.

The question of price formation (not to be confused with price level) became particularly acute around 2009 during the first wave of price renegotiations. The global recession then sharply reduced gas demand in Europe while gas supplied via long-term contracts was almost entirely linked to expensive oil products.

Spreads between oil-indexed and traded gas prices were then reaching minus €14.00/MWh, causing a massive cash-drain for European mid-streamers tied up by take-or-pay clauses.

In price review arbitrations in 2010-11, European mid-stream suppliers were pushing for changing long-term contract pricing to hub indexation, arguing that European hub trade was sufficiently developed to provide transparent price benchmarks. Already then, producers said they could market and sell their volumes directly on the hubs, eliminating mid-stream companies altogether. European suppliers were reduced to service providers that saved producers the time and cost of setting up their own trading and distribution units, having to fully cover their margin-collateral and take on customer default risk.

Norway already then reduced its long term contract volumes and started marketing gas directly on European hubs. Russia's Gazprom only launched its Electronic Sales Platform (ESP) in September 2018.

From the producer perspective, long-term contracts' main raison d'être is ensuring steady and predictable revenue streams for investment in field and infrastructure development. With the increasing political push to divert investment from fossil fuels to alternative sources of energy the importance of this justification may be waning. When it comes to maximising short-term profits from selling at a tight market and using price arbitrage, current hub prices present almost a once-in-a-lifetime opportunity.

Norwegian suppliers were quick to take it on. Norwegian long-term contracts are expiring and not being renewed. According to preliminary figures, only 40% of Norwegian gas exports were under long-term contracts in 2021 (see separate story).

The question remains, however, who will benefit from this change.

"The reason for [non-renewal of long-term contracts] is the tight gas market in Europe and likely also in Asia going forward," said Morten Frisch, Senior Partner at Morten Frisch Consulting (MFC). "Currently Norwegian gas producers can get very good short-term and spot prices when selling their production on UK and EU gas hubs. This is the result of EU and UK policies, now backfiring on gas buyers," he added.

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Wolfgang Peters, Managing Director of The Gas Value Chain Company said long-term contracts will stay in the game.

"I would doubt there will be no initiative to renew long-term contracts, albeit hub-indexed, in the coming years because producers will want to shun the financial burden and counterparty credit risk they would incur if they market all their production by themselves," he said.

Back in 2009, European buyers were suffering from a lack of flexibility from producers in the face of a sudden fall in demand. Now they are exposed to global demand and price volatility while the relative predictability of long-term deals is being taken away. **Katya Zapletnyuk**

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